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BEFORE THE

POSTAL RATE COMMISSION

Docket No. R2000-1

POSTAL RATE AND FEE CHANGES, 2000

REPLY BRIEF OF ASSOCIATION FOR POSTAL COMMERCE AND MAIL ADVERTISING SERVICES ASSOCIATION INTERNATIONAL

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The Association for Postal Commerce and Mail Advertising Services Association International (collectively, PostCom) submit this reply brief in accordance with the schedule established by the Commission. The brief addresses four points. It establishes that the criticisms of Sander Glick's drop shipment discount analysis and, to the extent that they actually are criticisms, automation pass through arguments made in the initial brief of the United States Postal Service (Postal Service Brief) are wrong. It then examines the defenses of the testimony of Dr. Clifton and Mr. Callow made, respectively, in the Joint Initial Brief of American Bankers Association and National Association of Presort Mailers (ABA&NAPM Brief) and the Initial Brief of the Office of the Consumer Advocate (OCA Brief).

I. *The Postal Service Brief's Position On Drop Shipment Discounts is Half Right.*

The Postal Service's presentation on the subject of drop shipment discounts confuses, or makes confusing, two related but analytically very separate ideas. The first of these is the importance of maintaining or increasing the differential in absolute dollar terms between drop shipment discounts, e.g., DBMC/DSCF. PostCom presented testimony on this issue in R97-1. Its industry witness, Joseph Schick, demonstrated from a business perspective why reducing the difference between the BMC and SCF destination entry discount from .5 cents to .3 cents would have undesirable consequences. See PRC Op. R97-1 ¶ 5493-94. The Commission found Mr. Schick's arguments persuasive. Id. at paragraph 5501. The Postal Service has taken this learning to heart and, in the proposed drop shipment discounts in this case, has retained or increased the differential between varying levels of drop shipment. Postal Service Brief at VII-195. This is clearly the right outcome.

However, the Postal Service goes on to suggest that the drop shipment cost savings passthroughs proposed in this case are somehow better than the 73 percent (DBMC) and 77 percent (DSCF) testified to by Mr. Moeller. USPS-T-35 at 15, lines 10-11.

> In this filing, had the incremental savings between the tiers been used as the basis for the DSCF and DDU discounts, passthroughs of 100 percent and 95 percent, respectively would have resulted in per-piece differentials identical to those proposed. USPS-T-35 at 16 n.32.

Postal Service Brief at VII-195. The portion of Mr. Moeller's testimony to which the Postal Service Brief cites is slightly clearer as to how the larger percentages are calculated:

> If 75 percent were chosen for both discounts, the gap in the discounts would not be maintained. To the extent the gap is considered the "discount," the "passthrough" underlying the discount is 93 percent for the DBMC/DSCF piece difference. Applying 100 percent to this gap would round to a 0.5 cent differential, which is the differential implicit in the proposed discounts.

Mechanically, the calculation is correct: The cost difference between savings associated with a DBMC entered piece (.02351 from USPS-LR-166-WP1, page 9) and a DSCF entered piece (.02888, id.) is .00536. The $.005 difference between the discounts proposed, .022 - .017, id., is 93.24 percent of actual savings.

Having penetrated the mechanics of this calculation, the Commission may properly wonder what it establishes. The fact that the difference in cost savings between two tiers of work sharing effort is roughly proportionate to the difference in the discount between the two tiers does not establish that either discount is correct. At most, it establishes that if one discount is at the correct level the second is close to right as well. That is not helpful in setting the first discount. A pass through of zero percent of BMC drop entered savings and 18 percent of the SCF entered savings would have roughly the same (96.18%) inter-tier cost/discount relationship.

Mr. Moeller's analysis has not sent the economically best signal to the mailer initially evaluating the costs and benefits of entering mail at the BMC. Mr. Glick's testimony provides that signal on the basis of well established economic theory. See PostCom et al.–T-1 at 3, Tr. 32/15717, lines 5-29.

The Postal Service brief disputes Mr. Glick's conclusion on the strength of an argument made by Mr. Moeller in answer to an interrogatory, Tr. 10/3855 and summarized at pages VII-196-97 of the brief. The argument is that, if the Commission passes through 100 percent of drop ship savings in successive cases, it will eventually reach the position where there is only piece of mail not yet drop shipped and, it will, by application of the logic in prior proceedings, have to set the drop ship discount at the cost of entering that last piece at a BMC.

This form of argument establishes both too much and too little. It establishes too much in two ways. It assumes that all mailers have drop shipping cost curves identical with the Postal Service's drop shipment cost avoidance curve. This is certainly not so. There are now and undoubtedly will continue to be mailers who do not drop ship and cannot afford to at the cost avoidance discounts that Mr. Glick advocates precisely because their costs of drop shipping are higher than the cost avoided by the Postal Service in having that drop shipment performed. It is also the case that, without regard to the percentage of the passthrough (77 percent or 100 percent), the phenomenon adverted to in the Postal Service's argument could occur. This outcome inheres in the way that these discounts and all others are constructed, inducing work-sharing efforts by all mailers who can save the Postal Service money by their efforts.

The argument also establishes too little. It may be that increasing destination entry discount will "over compensate" some mailers who would have drop shipped with a lesser discount. Absent the power to engage in highly variegated price discrimination, this is inevitable as long as some mailers can drop ship more efficiently that others. It also misses the point. As long as any mailer can drop ship more efficiently than the Postal Service can perform the same function, the mailer should be encouraged to do so. This is the precept of "the lowest combined cost" endorsed by the Postal Service Brief at VII-150. It is fully applicable here.

Neither Mr. Moeller nor the gloss on his testimony supplied in the Postal Service Brief succeeds at contradicting the core economic principle that 100 percent of costs saved by the Postal Service by mailer drop shipment should be passed through to the mailer in the form of discounts.

II. The Postal Service's Criticism Of Mr. Glick's Testimony Concerning The Efficiency Of The AFSM 100 Should Not Be Credited.

Sander Glick testified in PostCom et al. –T-1 at 6-19, Tr. 32/15720-33 that "THE VALUE OF AUTOMATION IS MUCH HIGHER THAN ESTIMATED BY THE POSTAL SERVICE". The Postal Service Brief, at VII-156 n. 1, takes issue with one element of that testimony. It urges that Mr. Glick's " . . . proposed IS factor of 70 percent is unrealistic" and argues that "the Postal Service's proposed 50 percent figure is far more reasonable and should be adopted."

The basis for this conclusion appears to be the following passage:

> Witness Glick's suggestion appears to ignore or discount other factors that tend to reduce IS factors, such as volume arrival patterns, operation clearance times, service standards, the distance between plants and delivery units, and the relocation of SM 881s and FSM 1000s.

Id. The Postal Service Brief offers no testimonial authority for the effect of its "other factors" on the IS factor in Mr. Yacobucci's model, as adjusted by Mr. Glick. So far as we are aware, there is none. The only testimony on this issue came from Mr. Glick in response to a Postal Service interrogatory establishing that he did not "ignore . . . other factors" but had them firmly in mind in reevaluating Mr. Yacobucci's IS factor:

> UPS/PostCom-T-1-6. Please see your testimony at pages 10-13. You state that, for eligible Standard A Mail flats, 70 percent of incoming secondary processing should be on an FSM in the test year (IS factor), an increase of 20 percentage points over witness Yacobucci's LR-I-90 factor of 50 percent.

> a. Please confirm that volume arrival and operation clearance times along with service standards (i.e. operating window) would have an impact on incoming secondary processing. If you do not confirm, please explain.
>
> b. Please confirm that the distance of a delivery unit from a plant with an FSM may prohibit incoming secondary processing on a FSM in the plant in order to transport it to the delivery unit in time for delivery. If you do not confirm, please explain.
>
> RESPONSE:
>
> a-b. Confirmed for preferential mail. Please note that these factors are not as relevant for Standard A mail as for preferential mail because, as USPS witness Unger stated in his testimony, "time sensitivity is not as frequently a factor for Standard A mailings." USPS-T-43 at 6. For more detail on this point, please refer to Section C of witness Unger's testimony (USPS-ST-43).
>
> Furthermore, as I calculated on pages 11-12 of my testimony, the Postal Service will have more capacity in the Test Year than they need to provide incoming secondary sorts on machines for all eligible flats in large zones. Because of this and the cost difference between FSM sorting and manual flat sorting, if the aforementioned factors are important for non-preferential mail (and therefore are even more important for preferential mail), I would expect that the Postal Service would appropriately use its FSM capacity to perform incoming secondary sorts on mailpieces destinating in small zones just as it did for the delivery point sequencing of letters. Kingsley Tr. 5/1980.

Tr. 32/15744.

Mr. Glick's use of a 70 percent IS factor is thoroughly considered and reasonable. The 50 percent IS factor used in Mr. Yacobucci's model implies that the Postal Service will not be using its flat sorting machines efficiently in the test year. As Mr. Glick establishes at pages 11-12 of his testimony, Tr. 32/15725-26, the Postal Service will have more than enough machine capacity in the test year to perform the incoming secondary sort of flats on all of the "approximately 9 billion machinable non carrier route flats that will destinate in zones where Postal Service plans to perform incoming secondary sorting on flat sorters." Postcom, et al.-T-1 at 12, Tr. 32/15726, lines 2-4. His 70 percent IS factor is conservative.

The only other criticism in the Postal Service Brief of Mr. Glick's presentation on automation issues is a back-handed one and appears in the Postal Service's treatment of Mr. Glick's advocacy of 100 percent pass through of drop shipment cost savings. There, the Postal Service takes Mr. Glick to task for not consistently recommending 100 percent pass throughs because of his advocacy of higher pass throughs in the discounts for automation flats. Postal Service Brief at VII-198. This misses the point. There may be circumstances in which pass throughs of less than 100 percent are appropriate. It is Mr. Glick's testimony that he does not believe the drop shipment arena to be one of these. There certainly are circumstances in which pass throughs of more than 100 percent are appropriate and the flats automation program is one of those. As the Postal Service's own testimony establishes, fairness to mailers who have made substantial investments in order to comply with the requirements of the Postal Service's automation program serves as strong defense for maintaining discounts near the levels at which they were initially set to induce those investments. USPS-T-35, 11 lines 15-17. Of course, mailers are not the only automation program participants with substantial investments in that program. The Postal Service too has invested very heavily betting on the success of flats automation. Unless it is able to maintain rates that have a reasonable prospect of keeping automation volume at reasonable levels, that investment will have to be recouped first by a dwindling population of automation mail and, if a downward spiral of volume continues, eventually by non-automation mailers as well. If there is to be a subsidy to the automation program, as apparently the economics of it require, it is far more prudent to subsidize rates in order to encourage movement toward automation than to put in place rates that will drive volume away from automation, insuring that subsidies from non-automation mailers will continue well into the future.

III. The Coverage And Rate Changes Advocated By Dr. Clifton For ABA & NAPM Are Not Justified By His Rationale's For Them.

The ABA&NAPM Brief recommends against use of data in the Order No. 1294 filings, in the calculation of automated FCLM cost avoidance. ABA&NAPM Brief at 9-13. It argues, alternatively, that if the Commission is to use these data the " . . . Clifton 'midpoint' measure of cost avoidance set forth in his August 30, 2000 Responsive Testimony . . . fully support[s] the FCLM discounts proposed by ABA&NAPM in this case." ABA&NAPM Brief at 15. This is not quite so, as the ABA&NAPM Brief subsequently recognizes. To get from the "midpoint" merger of 1998 and 1999 data calculated by Dr. Clifton to the rates recommended in his initial testimony, application of what he is pleased to call his balanced cost reduction analysis must be invoked. See ABA&NAPM Brief at 25-26; Responsive Testimony [of James A. Clifton] to August 25, 2000, Postal Service Supplemental Response to POR 116 at 3, Tr. 45/20146, lines 26-28. We argued in the initial brief filed in this proceeding for PostCom (at 11-13), that the intrusions on Postal Service managerial discretion advocated by Dr. Clifton in his penultimate piece of testimony and incorporated in his "midpoint" testimony were beyond the power of this Commission to carry out, even were it persuaded that his notions of cost shifting were good ones. That remains the case and there is not a word of defense for any conclusion to the contrary in the ABA&NAPM Brief.

To justify the rates that he proposes as originally he did on the basis of 1998 data, Dr. Clifton insisted that the cost coverages of Standard (A) mail and First-Class mail should be shifted in the direction of coverages recommended by this Commission in its docket No. R90-1 decision. The ABA&NAPM Brief recurs to this theme at page 26. But that brief does not explain, anymore than Dr. Clifton did, why the Commission must ignore intervening history in the balancing of contemporary Postal realities with the statutory criteria concerning coverage. The Commission must not permit itself to be mired in the record of R90-1, must reflect changes that have occurred since that time and should not heed Dr. Clifton's exhortations to turn back the clock. The shifts in cost coverage advocated by Dr. Clifton should not be recommended by the Commission.

IV. Neither Mr. Callow's Rate Freeze Nor His Rate Stability Proposal Should Be Recommended by the Commission.

The OCA Brief concedes, as does Mr. Callow, that their proposals to hold the rate for the first ounce First-Class stamp at 33 cents and for procedural steps toward rate stability must be considered in the alternative. Tr. 22/10246, lines 6-21, OCA Brief at 187. The Commission can not do both of those things in this case.

The OCA has now indicated its preference for favorable Commission action on its recommendation to maintain the rate for the first ounce First-Class stamp at 33 cents. OCA Brief at 187. The OCA Brief adds nothing in concept to the arguments advanced by Mr. Callow for this proposition. The brief, like Mr. Callow, urges that the

Commission's intentions concerning the relative coverage of First-Class and Standard (A) mail have been undermined by events, with First-Class mail contributing too much and Standard (A) mail too little to institutional costs. This position is untenable. The Commission has set rates in each of the cases analyzed by Mr. Callow. Those rates have been the amounts charged by the Postal Service from their inauguration in one rate case until their replacement in the next. The notion that some mail pieces, or categories of mail, are paying "too much" is just not viable. Every piece of mail pays precisely the rate prescribed by this Commission until that rate is changed by this Commission.

Looking at averages, as Mr. Callow and the OCA Brief do, is deceptive precisely because there are multiple rates within each of First-Class and Standard (A) mail and the rates do not make uniform contributions to institutional costs. Some rates contribute more than others. When the mix of mail varies from that projected by the Commission in a rate case, the average contribution for a class of mail can be different from that established by the Commission because that class of mail has more mail pieces with higher than average, or lower than average, contribution. This is the only plausible explanation for deviations from the class-wide average established by the Commission in any rate case.[1] There is no vice in this because every piece of mail is paying precisely the rate established for it by the Commission. Mr. Callow recognized the possibility of this explanation for the contribution phenomenon explored in his testimony, Tr. 22/10280, and Ms. Mayes testified to its probability. See Postal Service Brief at VII-31 and the matter quoted and cited there.

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[1] The initial PostCom brief (at 10) may have overstated the matter in asserting that a change in mail mix is the "only conceivable explanation" to the contribution history explored by the OCA. It is conceivable, but wildly improbable, that the Commission has regularly underestimated the actual costs of one or more rate categories of First-Class mail.

The rate stability proposal advanced by Mr. Callow and Mr. Gerarden for the OCA may deserve the study that the OCA Brief (at 187) advocates for it. It certainly is not suited for implementation now.

The rate stability proposal is not yet fully formed. Mr. Callow conceded on cross-examination that his proposal would entail a change in the way the Commission evaluates requested rates. Tr. 22/10254, lines 19-23. Mr. Callow conceded that he had not engaged in a rigorous examination of costs in his illustrative example of the workings of the rate stability proposal, Tr. 22/10248, lines 4-17, and admitted that the Commission would have to look at costs across the two rate cycles over which rate stability would be imposed. Id. 10257, lines 1-17. He conceded that the level of certainty in that enterprise would decline as the duration of rate cycles increased. Id., lines 17-24. Plainly the notion of a test year in the form provided for in 39 CFR § 3001.54(f) will not work in a stabilized rate rate case because, assuming a two year rate cycle and some level of inflation across the four year period, the rates in the first two years will have to be higher than necessary to defray the cost in those two years by the amount that the rates fall below costs in the second two years of the stabilized period. An understanding of how to accomplish the equilibrium illustrated by Mr. Callow's hypothetical does not seem an easy job and it is certain that considerably more methodological sophistication than offered by the OCA is necessary to balance the benefits against the burdens of the proposal. A closer legal analysis of the methodology necessary to carry out the proposal would also be prudent. C.f. Tr. 22/10263, lines 3-19, 10264, lines 9-19.

The OCA proposal to freeze the rate for the first ounce First-Class stamp at 33 cents is not warranted by the rationale advanced for it and the alternative proposal to impose a new methodology on the Commission's rate making processes is not sufficiently well developed for adoption at this time.

V. Conclusion

The PostCom proposal advanced in Mr. Glick's testimony for increasing drop shipment discounts to 100 percent should be recommended by the Commission. The cost saved by flats automation undertakings in the test year should be recognized at levels substantially higher than those reflected in the Postal Service's presentation. The cost coverage shifts advocated by Dr. Clifton in his initial testimony are not justified and the imposition of cost savings for work shared First-Class mail advocated in the balanced cost reduction proposal advanced by Dr. Clifton is not within the power of the Commission because it intrudes too intimately into the managerial discretion of the Postal Service. The rationale for the OCA's proposal for shifts in the relative coverage of institutional costs for First Class and Standard (A) mail is based on faulty analysis and should not be adopted. The OCA's rate stability proposal needs further development before the Commission can accord it meaningful consideration.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the rules of practice.

Ian D. Volner